FRBSF ECONOMIC LETTER

Number 2006-01, January 27, 2006

2006: A Year of Transition at the Federal Reserve

This Economic Letter *is adapted from remarks by Janet L. Yellen, President and CEO of the Federal Reserve Bank of San Francisco, delivered to the Los Angeles Chapter of the National Association of Business Economists in Los Angeles on January 19, 2006.*

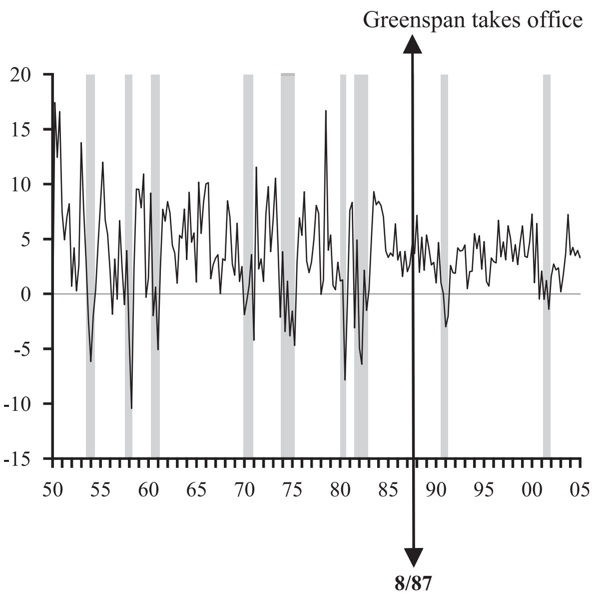
At the end of this month, Alan Greenspan will bring to a close his 18 years of distinguished service as Chairman of the Board of Governors of the Federal Reserve System. On February 1, Ben Bernanke will, in all likelihood, have been confirmed by the Senate and will therefore be in a position to become the new Chairman. With such a significant transition for the Fed just days away, this seemed like a natural time to spend a few moments looking back at the Greenspan Fed and offering some of my own views on what may lie ahead under a "Bernanke Fed."

The Greenspan years

Alan Greenspan has won many plaudits for skillfully managing monetary policy—and deservedly so. During the Greenspan years, the U.S. economy has been extraordinarily stable, with just two mild and short recessions (Figure 1), and with low and stable inflation for over a decade (Figure 2). Clearly, in the short time I have today, I cannot do justice to all the accomplishments, innovations, and successes the Fed has achieved under his leadership. So I'll focus on two aspects of policy that I believe have been especially important to this sterling record—a systematic, and therefore understandable and predictable approach to policy, and a growing emphasis on communication and transparency.

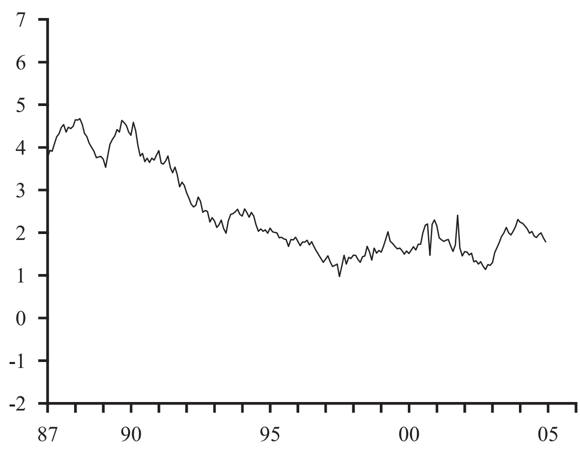
I will focus first on what I mean by a systematic approach to policy. While the Fed does not follow a policy rule, it has been consistent in its approach to achieving its dual mandate—keeping inflation low and stable and promoting maximum sustainable employment. For example, when faced with an unwelcome increase in inflation, the Fed has consistently engineered a strong funds rate response. Indeed, at times, the Fed has taken *preemptive* mea-

Figure 1
U.S. real GDP growth
% at an annual rate



Source: Bureau of Economic Analysis.

Figure 2
Core PCE price inflation during Greenspan years
% change over 12 months



Source: Bureau of Economic Analysis.

sures, shooting inflation before it "sees the whites of its eyes"; for example, in 1994, it raised the funds rate aggressively in response to indicators suggesting that demand had exceeded capacity in labor and product markets, even though inflation itself had not shown much of a rise. Likewise, when faced with an unemployment rate that diverges from our best estimates of so-called "full" employment, the Fed's response also has been consistent and strong. Consider the start of the 1990s, when the unemployment rate was rising—even though inflation was some distance from price stability, the Fed chose to ease policy.

This systematic, consistent approach has enhanced the ability of financial markets to anticipate the Fed's response to economic developments and to respond themselves in advance of the Fed. Such market responses strengthen and speed the transmission of policy to the economy and conceivably enhance economic stability. Moreover, such an approach helps build the public's confidence in the Fed's commitment to low and stable inflation; this, in turn, may well make it easier for the Fed to respond to fluctuations in labor and product markets, because there is less risk that an easing of policy will unleash a wave of inflation fears.

As successful as this systematic approach has been, I should note that it has by no means been a straitjacket for policy during the Greenspan years. Rather, policy also has been flexible when unusual circumstances called for it. Let me give just one example. In the latter part of the 1990s, the Greenspan Fed—and Greenspan in particular—was quick to spot the productivity surge and to realize that it meant that the unemployment rate could be significantly lower than previously thought, for a time, at least, without igniting inflation. This led to a policy of "forbearance," capturing the benefits of lower unemployment while continuing to move toward price stability.

Now let me turn to the second aspect of policy, namely, the increased emphasis on communication and transparency. One of the first steps in this direction occurred in 1994, when the FOMC first started issuing press releases after its meetings that explicitly announced changes in the federal funds rate target. Over the decade or so since then, the press release has come to include a statement about the balance of risks to the attainment of its dual mandate, and at least some indication of where policy may go in the future. This enhanced transparency works in tandem with the systematic approach I discussed, because it, too, helps the markets anticipate the Fed's response to economic developments.

A good example of this was the threat of outright deflation in 2003. The FOMC wanted policy to err on the side of accommodation until the threat had passed. With Japan's unfortunate experience in the 1990s as a clear object lesson, the Committee believed that the costs of slipping into deflation would be worse than the costs of a bit of overstimulation to economic activity. This risk management approach to policy was communicated to the public when the FOMC stated that, "In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period." This forward-looking language itself seems to have helped keep long-term interest rates low, thereby minimizing the risk of deflation.

Of course, there have certainly been other developments in policy during the 18 years of Greenspan's chairmanship that have contributed to its success in achieving its dual mandate. But I believe these two—a systematic approach to policy and more communication and transparency—are particularly noteworthy. They have helped strengthen public confidence in the Fed and thereby helped anchor inflation expectations to price stability.

Looking ahead to the "Bernanke years"

These achievements provide a great foundation for the new Chairman, Ben Bernanke. Having observed him when he was a member of the Board of Governors from 2002 to 2005, and being familiar with his remarkable body of research on macroeconomic policy, I feel pretty confident that he places an equally high value on a systematic approach as well as on transparency and communication. Indeed, he has stressed that clear communications about the central bank's approach, its objectives, and its assessment of the economy are necessary to reduce uncertainty and stabilize expectations. And any of you who have read the speeches he gave while he was a Governor will know that he is a consummate communicator and teacher.

One area where he has differed with Chairman Greenspan is on how to define "price stability." Of course, both see price stability as a prime objective of policy. But for Chairman Greenspan, the definition has been behavioral—that is, he would say that we have achieved price stability when inflation is low enough that it does not materially affect people's economic decisions. In contrast, well before Bernanke was nominated to be Fed Chairman, he said that he would like to see the establishment of a numerical objective for price stability (see Bernanke 2003). Since his nomination, he has said that he would not institute such an approach without a consensus among FOMC members.

For my part, I'm sympathetic to the idea of a quantitative objective for price stability, as I agree that it enhances both Fed transparency and accountability. I have previously articulated my views on this. I see an inflation rate between 1% and 2%, as measured by the core personal consumption expenditures price index, as an appropriate price stability objective for the Fed. However, I also think it is critically important that a numerical inflation objective not weaken our commitment to a *dual* mandate that includes full employment. Therefore, I would see the numerical objective as a long-run goal and would want the Committee to have a flexible timeframe within which to maintain it. We've done a good job under Chairman Greenspan of promoting both price stability and full employment. I believe that a numerical long-run objective for inflation will enhance our ability to maintain that success even in the face of the significant challenges that may come up.

Conclusion

Let me wrap things up by saying that I hope these brief remarks have given you some appreciation of the remarkable achievements of the Greenspan Fed over nearly two decades and a glimpse into some issues that may arise in the "Bernanke Fed." As a member of the FOMC, of course, I am going to be "at the table," and in the thick of the transition. It particularly pleases me to say that, with the Fed's increased emphasis on communication and transparency, you and the rest of the public are going to have a pretty good view of how things play out yourselves. So stay tuned—I think it's going to be a fascinating year for us all!

Janet L. Yellen
President and Chief Executive Officer

Reference

Bernanke, Ben S. 2003. Remarks at the 28th Annual Policy Conference: "Inflation Targeting: Prospects and Problems." Federal Reserve Bank of St. Louis, St. Louis, Missouri (October 17). http://www.federalreserve.gov/boarddocs/speeches/2003/20031017/default.htm

Economic Research
Federal Reserve Bank
of San Francisco

P.O. Box 7702
San Francisco, CA 94120
Address Service Requested

**PRESORTED
STANDARD MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.**

Printed on recycled paper
with soybean inks

Index to Recent Issues of *FRBSF Economic Letter*